Supreme Court, U.S.
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No. 96-708

In the Supreme Court of the United States

OCTOBER TERM, 1996

GREENE COUNTY BANK, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE FEDERAL DEPOSIT INSURANCE CORPORATION IN OPPOSITION

WALTER DELLINGER
Acting Solicitor General
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

WILLIAM F. KROENER
General Counsel
THOMAS A. SCHULZ
ANN S. DUROSS
Assistant General Counsel
COLLEEN B. BOMBARDIER
LORETTA R. PITT
Senior Counsel
THOMAS L. HOLZMAN
Counsel
Federal Deposit Insurance Corporation
Washington, D.C. 20429

QUESTION PRESENTED

Whether the court of appeals correctly affirmed the authority of the Federal Deposit Insurance Corporation, under 12 U.S.C. 1818(b)(1), to enjoin as "unsafe or unsound" a practice that causes abnormal risk or loss or damage to a federally insured financial institution.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-7a) is reported at 92 F.3d 633. The decisions of the Board of Directors of the Federal Deposit Insurance Corporation (Pet App. 103a-129a) and the administrative law judge (Pet. App. 8a-102a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 7, 1996. The petition for a writ of certiorari

was filed on November 4, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

The Federal Deposit Insurance Corporation (FDIC) insures the deposits of commercial banks, 12 U.S.C. 1821(a), and examines the banks for safety and soundness to protect the nation's financial system and the deposit insurance funds, 12 U.S.C. 1820(b). See generally *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 327, 329 (1963). The FDIC has a variety of tools to carry out its regulatory mission. Critical among those is its authority to issue cease and desist orders to restrain practices that it finds, in the exercise of its expert judgment, to be unsafe or unsound. 12 U.S.C. 1818(b)(1).

Congress first granted the federal banking agencies the authority to issue cease and desist orders to remedy unsafe and unsound practices, and to remove bank directors or officers who had engaged or participated in such practices, when it enacted the Financial Institutions Supervisory Act of 1966 (FISA), Pub. L. No. 89-695, §§ 101, 102(a), 201, 80 Stat. 1029-1030, 1038-1039, 1046-1048. It intended thereby to provide the banking agencies with flexible supervisory tools, so that they would not be limited to placing the affected institution in receivership, terminating its deposit insurance, or letting the problem fester. S. Rep. No. 1482, 89th Cong., 2d Sess. 1, 5-6 (1966); see also *Gulf Federal Savings & Loan Ass'n* v. *FHLBB*, 651 F.2d 259, 263 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982). Congress has not attempted specifically to define or comprehensively to catalogue those "unsafe or unsound practices" that may give rise to a cease and desist order, nor could it effectively do so. The phrase

embodies "a flexible concept which gives the administering agency the ability to adapt to changing business problems and practices in the regulation of the banking industry." *Seidman* v. *OTS*, 37 F.3d 911, 927 (3d Cir. 1994); accord *Groos National Bank* v. *Comptroller of the Currency*, 573 F.2d 889, 897 (5th Cir. 1978) ("The phrase 'unsafe or unsound banking practice' is widely used in the regulatory statutes and in case law, and one of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies.").

1. This case involves an administrative proceeding, initiated by the FDIC, arising out of petitioner's use of financial futures. When properly calibrated and monitored, an investment in futures can protect a bank from interest rate risk (*i.e.*, the risk that, when interest rates rise, the rates that a bank must pay its depositors may increase more quickly than the rates that it can charge its borrowers, leading to a decline in its net interest income). A bank can "hedge" against its interest rate risk by acquiring short positions in the futures market, because the value of those positions will rise if interest rates rise, offsetting the increase in the cost of the bank's deposit liabilities. Conversely, if interest rates decline, the short positions will decrease in value, but that loss will be offset by the decrease in interest that the bank must pay to attract and retain deposits. See Pet. App. 107a, 119a.

Although the use of financial futures can protect a bank from interest rate risk, because they are highly leveraged transactions, a bank's investments in futures are fundamentally more risky than its core activity of loaning money to customers. In the event

of a default on a loan, the bank is unlikely to lose much more than the nominal amount of the loan, if that. In contrast, an investment in a futures position can result in a loss many times the amount of the investment. The use of futures therefore requires careful attention to detail and demonstrated technical competence to avoid threatening a bank's financial soundness.

2. a. Petitioner is a small, state-chartered, federally insured bank, with fewer than $20 million in assets. Historically, it has had a significant and unusually high level of balance sheet exposure to interest rate risk, which, notwithstanding the FDIC's repeated admonitions, it made no attempt to address. Pet. App. 106a-107a. Petitioner's failure voluntarily to act to control its interest rate risk exposure led the FDIC in August 1991 to initiate cease and desist proceedings under 12 U.S.C. 1818(b)(1).[1] Pet. App. 108a. The parties settled those proceedings in February 1992 by entering into a Memorandum of Understanding (MOU). *Ibid.* In the MOU, petitioner agreed to develop written policies

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[1] Section 1818(b)(1) provides in pertinent part

> If, in the opinion of the appropriate Federal Banking agency, any insured depository institution * * * has engaged * * * in an unsafe or unsound practice in conducting the business of such depository institution, * * * the agency may issue and serve upon the depository institution * * * a notice of charges in respect thereof. * * * [I]f upon the record made at [a] hearing, the agency shall find that any * * * unsafe or unsound practice specified in the notice of charges has been established, the agency may issue and serve upon the depository institution * * * an order to cease and desist from any such * * * practice.

dealing with interest rate risk exposure and the use of futures to address that risk, and to provide specific analysis and justification each time petitioner used futures to hedge interest rate risk. Petitioner was also required to obtain prior approval from its board of directors of any plan to engage in futures activities, in accordance with an FDIC Policy Statement on the use of futures that was incorporated by reference in the MOU. *Id.* at 3a, 106a-110a. As the FDIC's Board explained (*id.* at 121a):

> In the context of these risky investments, the MOU and FDIC Policy Statement serve two purposes. One is substantive: ensuring that an institution has given careful consideration to all relevant factors prior to making these investment decisions. The other is procedural in the sense of recordkeeping: ensuring that examiners, auditors, and persons within a financial institution are able to ascertain the steps in the decisionmaking process in order to review the appropriateness of the transactions.

b. Although petitioner made an effort to comply with the MOU, significant areas of non-compliance continued to exist. Of particular concern, in late 1992 petitioner began to acquire quantities of long futures contracts and equal quantities of short futures with different maturities. Those "spread" positions were speculative investments, in that they were designed not for hedging risk but instead to create income. Petitioner's use of futures for speculation violated the MOU because, at the time, petitioner had no policy that authorized its acquisition of spread positions. Petitioner's investment in futures spreads was not approved by its board of directors until March

1993, and the only document in the record explaining petitioner's investment strategy was undated. Pet. App. 4a, 113a-114a, 121a-122a.

Petitioner's failure regularly to measure and monitor its interest rate risk also violated the MOU. That failure was particularly significant because calculations done at the time by bank regulators and outside professionals indicated that petitioner's interest rate risk had declined, which suggested that petitioner ought to have been considering a concomitant decrease in its short futures. Short positions that are unnecessary for hedging purposes are speculative; they represent nothing more than a bet that interest rates will rise. Pet. App. 4a-5a, 112a-113a, 123a-124a.

3. In July 1993, the FDIC initiated cease and desist proceedings under 12 U.S.C. 1818(b)(1), asserting that petitioner's conduct in violation of the MOU constituted unsafe and unsound banking practices. Pet. App. 2a. After a hearing, the ALJ recommended that no cease and desist order issue. *Id.* at 8a-99a. In the ALJ's view, petitioner had complied with the MOU in most material respects, and its investment and trading practices were not unsafe or unsound. *Id.* at 99a.

The FDIC's Board of Directors reversed the ALJ's decision. Pet. App. 103a-129a. Although it agreed with the ALJ that petitioner had made an effort to comply with the MOU, the Board concluded that significant areas of non-compliance remained. *Id.* at 2a, 127a-128a. The Board found that petitioner's failure to properly authorize and document its investments in futures violated the express terms of the MOU and the FDIC Policy Statement. *Id.* at 125a. Those deficiencies were serious, the Board explained, both because prior approval and documentation are "crucial

to well-informed decisionmaking," and because contemporaneous documentation permits "FDIC examiners and others to evaluate the prudence of the decisions made." *Id.* at 125a-126a.[2] Concluding that the discrepancies in petitioner's procedures and documentation respecting futures were "unsafe and unsound practices" that exposed petitioner to "abnormal risk of loss," the Board issued a cease and desist order requiring petitioner to do what it had already agreed to do—comply with the MOU. *Id.* at 128a.[3]

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[2] The Board further elaborated (Pet. App. 121a):

> Ultimately, the requirements at issue in this case are analogous to the requirements that apply when a financial institution makes a loan or any other investment: to carefully consider the merits of the investment, to properly document the decisionmaking process, and to have compliance personnel verify these steps. An institution would no more make a loan to a borrower without first considering the borrower's ability to repay, documenting that consideration, and having some independent check on those functions, than it would make an investment in futures for the purpose of hedging without ascertaining and documenting the extent of interest rate risk, and subjecting those calculations to independent verification by auditing personnel. To endorse the Bank's conduct in this case would be to endorse something less than the "prudent person" standard of care required of bankers.

[3] Contrary to petitioner's argument (Pet. 5 n.2), the FDIC's issuance of a cease and desist order directing petitioner to specifically perform its existing obligations under the MOU was a modest corrective action. While petitioner asserts (Pet. 6 n.3) that the FDIC's concerns should have been "dealt with in the regular examination process," petitioner fails to explain how suggestions made in the course of examination would have succeeded when a formal settlement had not. Given petitioner's failure to abide by the MOU, issuance of a cease and desist order constituted an appropriate, and quite measured,

4. The court of appeals denied petitioner's petition for review. Pet. App. 1a-7a. The court held that substantial evidence supported the Board's findings that petitioner violated the terms of the MOU and the FDIC Policy Statement by failing to "document and obtain approval of the acquisition of a number of spread positions," and by failing to "calculate and analyze its interest rate exposure on a regular basis." *Id.* at 4a. It concluded, moreover, that the record contained substantial evidence to support the Board's conclusion that petitioner's "failure to comply with the MOU constituted an unsafe and unsound banking practice, justifying the issuance of a cease and desist order." *Id.* at 5a. The court rejected petitioner's argument that the "unsafe and unsound" standard encompasses only those "practices having a reasonably direct effect on the Bank's financial soundness," observing that, in the Eighth Circuit, it is "well-settled" that "an 'unsafe or unsound practice' exists where the conduct is 'deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder.'" *Id.* at 6a.

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next step. Although petitioner correctly perceives (Pet. 5 n.2) that a failure to comply with the MOU's modest approval and documentation requirements will now expose it to further and more serious sanctions, compliance with the MOU is entirely within petitioner's control.

ARGUMENT

Petitioner argues (Pet. 7-15) that the court of appeals erred in holding that a bank's practice is "unsafe and unsound," warranting the issuance of a cease and desist order under 12 U.S.C. 1818(b)(1), if its continuance might result in an abnormal risk or loss or damage to the institution. In petitioner's view, a practice may be enjoined as unsafe or unsound only if it "ha[s] a reasonably direct effect on an institution's overall financial soundness." Pet. 7. The court of appeals correctly rejected that standard, which cannot be reconciled with a fair reading of the relevant statutory provisions or the legislative history.

Petitioner correctly observes (Pet. 10-13) that other courts of appeals have adopted a higher threshold for a finding of unsafe or unsound banking practices than that applied by the FDIC and the Eighth Circuit in this case. See *Gulf Federal Savings & Loan Ass'n* v. *FHLBB*, 651 F.2d 259 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982); *Seidman* v. *OTS*, 37 F.3d 911 (3d Cir. 1994); see also *Johnson* v. *OTS*, 81 F.3d 195 (D.C. Cir. 1996).[4] Those courts, however, have not analyzed the compatibility (*vel non*) of their formulation of that standard with the overall statutory enforcement scheme. We believe that that analysis strongly supports the Eighth Circuit's ruling, and that, upon a full airing of the issue, the courts of appeals that currently disagree with the Eighth Circuit will reconsider the matter. Because the existing

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[4] Although petitioner also cites *Hoffman* v. *FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990), the court in that case noted the existence of both standards without adverting to any difference or choosing between the two.

conflict among the circuits may be resolved of its own accord, it does not warrant the Court's review at this time.

1. To the extent petitioner suggests (Pet. 7 n.4) that a practice may not be enjoined unless it has already had a substantial adverse effect on a bank's financial integrity, that argument is defeated by the plain text and obvious import of the statute. A practice is "unsafe" if it "exposes to danger" (*Webster's Third International Dictionary* 2509 (1976)); it is "unsound" if it is "not based on proven practice" or "established procedure" (*id.* at 2511). A practice is unsafe or unsound, therefore, if it is imprudent and carries an abnormal risk of harm.

Nothing in the text or legislative history supports petitioner's view that the FDIC was required to prove that petitioner's practices had already had a substantial adverse effect on its financial integrity. Rather, the test is prophylactic in nature. See *Saratoga Savings & Loan Ass'n* v. *FHLBB*, 879 F.2d 689, 693 (9th Cir. 1989). Just as one who drives drunk or at excessive speeds engages in an "unsafe practice" that may be curtailed irrespective of whether he (or others) have already been injured as a result of his conduct, a bank that engages in careless or risky activities engages in unsafe or unsound practices that may be enjoined without regard to whether it (or its depositors or the deposit insurance fund) have to that point suffered losses therefrom. Although the courts of appeals have come to varying conclusions about the magnitude of risk necessary to trigger corrective regulatory action, even the decisions most favorable to petitioner in that regard make clear that a cease and desist order may issue upon a showing of abnor-

mal risk to the institution. See *Seidman*, 37 F.3d at 926-928, 932; *Gulf Federal*, 651 F.2d at 264-265.

2. To the extent petitioner's argument is that a practice may not be enjoined as "unsafe or unsound" unless or until it poses a reasonably direct risk to an institution's financial stability, that argument is also without merit. In considering petitioner's complaints over what it believes to be undue governmental interference in its business affairs, it bears emphasis at the outset that petitioner operates not in any common private sector business, but in "one of the longest regulated and most closely supervised of public callings." *Fahey* v. *Mallonee*, 332 U.S. 245, 250 (1947); accord *United States* v. *Gaubert*, 499 U.S. 315, 333 (1991); *Philadelphia National Bank*, 374 U.S. at 329-330.

In interpreting the phrase "unsafe or unsound," the courts (including those upon which petitioner relies) have looked for guidance to the construction suggested by Chairman Horne of the Federal Home Loan Bank Board in a memorandum submitted to Congress at the time of FISA's enactment. Chairman Horne stated that

> [g]enerally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the *possible* consequences of which, *if continued*, would be an abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.

112 Cong. Rec. 26,474 (1966) (emphasis added).

The standard applied by the FDIC and the court below is precisely that articulated by Chairman

Horne. See Pet. App. 6a (practice need only be one that is "deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss"). Although the Fifth Circuit in *Gulf Federal* recognized Chairman Horne's articulation as "authoritative" (651 F.2d at 264), it departed from that definition by adding its own more restrictive judicial gloss. See *id.* at 267 ("The 'unsafe or unsound practice' provision * * * refers only to practices that threaten the financial integrity of the association.").[5]

The judicial gloss applied by the Fifth Circuit cannot be reconciled with the text and structure of the overall statutory enforcement scheme. In addition to triggering cease and desist orders, unsafe or unsound banking practices may form the bases for removing officers or directors from an institution and/or prohibiting their further participation in the industry. See 12 U.S.C. 1818(e). Because those are more severe sanctions, however, banking agencies seeking removal or prohibition orders must satisfy an "effects" test in addition to proving the existence of unsafe or unsound practices. The agency must show that, as a result of the unsafe or unsound practice, the institution "has suffered or will probably suffer financial loss or other damage," or that "the interests of the insured depository institution's depositors have been or could be prejudiced." 12 U.S.C. 1818(e)(1)(B)(i) and (ii). If, as *Gulf Federal* suggested, a practice could not be deemed "unsafe or unsound" unless it "threatened the financial integrity of the associa-

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[5] The Third and District of Columbia Circuits adopted the standard enunciated in *Gulf Federal* with little independent analysis. *Seidman*, 37 F.3d at 927-928; *Johnson*, 81 F.3d at 204.

tion," proof of an unsafe or unsound practice would necessarily establish the adverse "effect" required to obtain an order of removal and prohibition, rendering Congress's specific requirement of the latter showing for removal or prohibition superfluous.

It is, moreover, difficult to reconcile petitioner's view that a banking agency may enjoin as "unsafe or unsound" only those practices that directly threaten a depository institution's financial integrity with the fact that a banking agency may without question issue a cease and desist order to enjoin a depository institution's violation of any "law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the depository institution or any written agreement entered into with the agency" (12 U.S.C. 1818(b)(1)), irrespective of how minor or technical the violation. See *Oberstar* v. *FDIC*, 987 F.2d 494, 502 (8th Cir. 1993) ("Proof of misconduct alone entitles the agency to invoke its broad Cease and Desist enforcement powers.").

Neither the Fifth Circuit in *Gulf Federal*, nor the Third and District of Columbia Circuits which followed its lead, analyzed the "unsafe and unsound practices" requirement of Section 1818(b) in light of the independent "effect" requirement in Section 1818(e).[6] It would be appropriate under these circum-

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[6] At the time of the *Gulf Federal* decision, the required effect was "that the bank has suffered or will probably suffer *substantial* financial loss or other damage or that the interests of its depositors could be *seriously* prejudiced" by reason of the unsafe or unsound practice. 12 U.S.C. 1818(e)(1) (1982) (emphasis added); accord 12 U.S.C. 1464(d)(4)(a) (1982) (federal savings associations); 12 U.S.C. 1730(g)(1) (1982) (state chartered savings associations). The italicized modifiers were de-

stances for this Court to permit further development of the issue in the lower courts.

3. In any event, further review is not warranted in this case because the FDIC's cease and desist order would have been upheld even in those courts of appeals that currently apply the *Gulf Federal* standard. In those courts, the question is whether the practice, *if continued*, would threaten the financial integrity of the institution. As we have explained, the use of futures for hedging and speculation requires substantial monitoring and analysis. Although petitioner's failure properly to analyze and document its futures market activities with respect to the particular transactions at issue did not in fact result in a net loss to the institution, the FDIC made a predictive judgment that those practices, *if continued*, could lead to an abnormal risk of loss. Pet. App. 126a, 128a. In light of the highly leveraged nature of futures transactions, and petitioner's use of futures for speculation, such losses could well threaten petitioner's financial integrity.

The FDIC's order in this case was also based on its conclusion that petitioner's failure contemporaneously to document its futures activities in accord with the MOU hindered the FDIC's ability to examine and evaluate the prudence of those activities. Pet.

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leted when Congress modified the requirements for removal and prohibition in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183. The legislative history of FIRREA makes clear that the changes were designed to facilitate the banking agencies' ability to obtain removal and prohibition orders. S. Rep. No. 19, 101st Cong., 1st Sess. 374-375 (1989); H.R. Rep. No. 54, 101st Cong., 1st Sess. Pt. 1, at 468 (1989); H.R. Rep. No. 209, 101st Cong., 1st Sess. 444 (1989).

App. 126a. In *Seidman*, the Third Circuit affirmed the Office of Thrift Supervision's conclusion that an attempt to hinder a banking agency's investigation constituted an unsafe and unsound practice, because that course of conduct rendered the agency "unable to fulfill its regulatory function" and "str[uck] at the heart of the regulatory function." 37 F.3d at 936-937. The court held that Seidman's actions, "if continued, would pose an abnormal risk of damage to the agency," thus satisfying the test enunciated in the Horne Memorandum. *Id.* at 937.[7] Petitioner's failure to comply with the MOU likewise hindered the FDIC's ability properly to perform its regulatory oversight function.

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[7] The Horne Memorandum listed as examples of unsafe and unsound practices conduct quite similar to that at issue here: (1) "[D]isbursement of loan funds on construction in progress without proper safeguards for the association's security for the amounts advanced"; and (2) "accounting procedures which fail to show correctly the condition, operation, and trends of the institution, thus providing misleading information for management decisions." 112 Cong. Rec. 26,474 (1966).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

WILLIAM F. KROENER
General Counsel

THOMAS A. SCHULZ
ANN S. DUROSS
Assistant General Counsel

COLLEEN B. BOMBARDIER
LORETTA R. PITT
Senior Counsel

THOMAS L. HOLZMAN
Counsel
Federal Deposit Insurance Corporation

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